DOW THEORY LETTERS INC.

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THE MARKET: Nothing that happened last week should have come as even a mild surprise to readers of these Letters. I have been writing about monetary problems and gold for many months, and the eruption of interest rates in Britain and in the U. S. was never a matter of "whether"; it was a matter of "when."

Letter 271 directed attention to the long "line-like" structure which had been building in the Industrial Average since late September. It was also noted that the Rails had been fluctuating for months between their August low of 206.35 and their October all-time high of 224.91 (see Chart 1). Letter 271 continued "For those who have been 'sweating through' a difficult period, there exists only one signal which will gladden their hearts; that is a joint rise by both Averages to new highs (preferably on increasing volume).

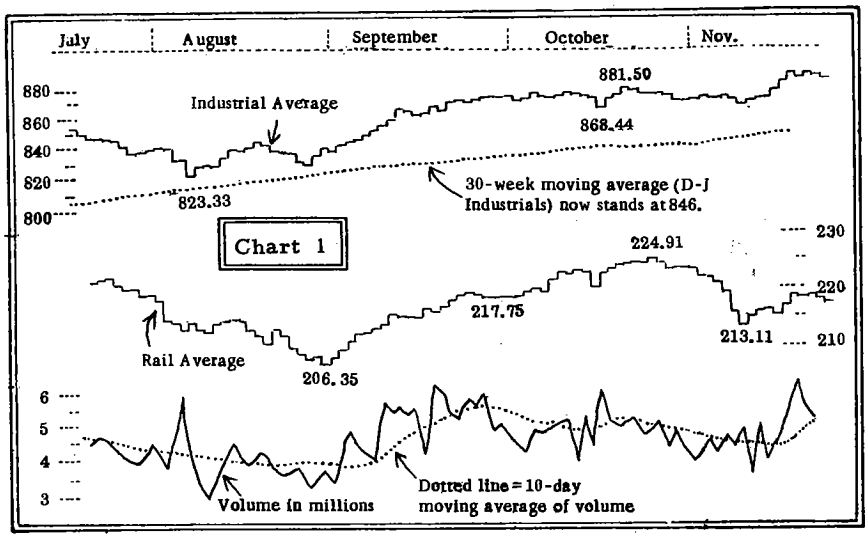
On November 17 Industrials surged to a new record high — amid the applause of all Wall Street. The rise was not confirmed by the Rail Average. This, then, is as good a time as any to repeat that from the Dow Theory standpoint a bullish indication in a single Average is no better than none at all.

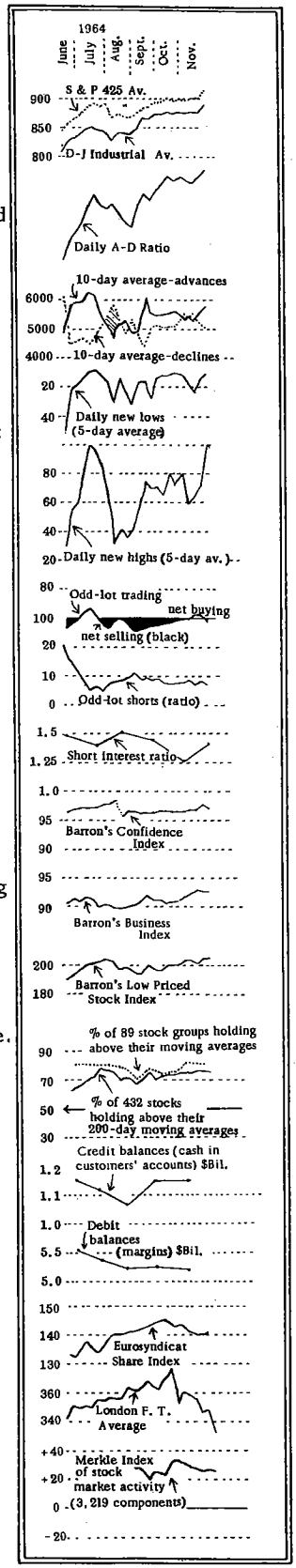
The worth of the solo Industrial breakout was immediately put to the test. Selling dampened the market on Monday (November 23) as news of the British bank rate boost was announced. Further broad selling came in on November 24 following the news of a rise to 4% in the U. S. discount rate (not to be left out, Canada also announced that she was increasing her bank rate to 4¼%).

There is little point in speculating as to the possible seriousness of the current decline. Significant nearby "check-levels" have been provided by the Averages, and it would be better to watch these than to indulge in wishful thinking. A rise by Rails above their October peak of 224.91 (with Industrials moving higher) would reconfirm the bullishness of both the primary and secondary trend. On the other hand, a joint penetration of 868.44 by Industrials and 213.11 by Rails would suggest that a decline of at least secondary importance was in the making. A further slide below 823.33 and 206.35 (the August lows) would constitute something that "the bears could really get their teeth into."

The Composite Chart shows the two Averages breaking to new highs confirmed by the A-D ratio. The 10-day average of advances is also in the bullish position. On November 20 the 5-day average of daily new highs climbed to 101, 2 above the July peak. Although it immediately turned down, this was nevertheless a hopeful rise. Odd-lotters, after a few days of respite, have once again crept to the selling side of the market. The short interest ratio rose from last months 1.26 to 1.42, and this must be considered neutral-bullish. Barron's Confidence Index backed off to 97.1 after setting a new peak of 97.7. Of 432 stocks tabulated here weekly, 75% are now holding above their moving averages — still well above the critical 50% level. Credit and Debit balances showed changes that were so slight that I can only repeat what was detailed in Letter 267 -- these two studies suggest that it is rather late in the game. The Eurosydicat Index has been in a shallow decline since October as has the Merkle Index. The London Index has come to earth with a breathtaking "thump," and there is a good deal more about this in a later section of the Letter.

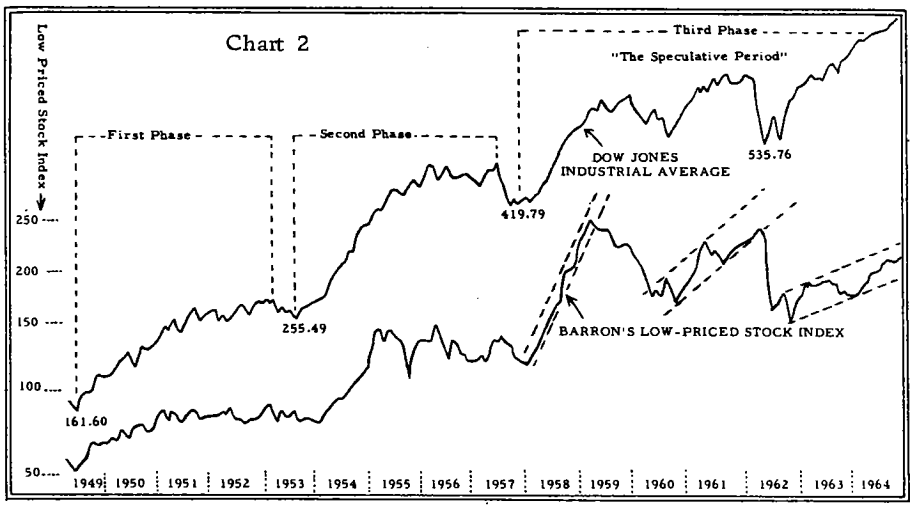
Conclusion: The sum total of the Averages and the indicators seem to present a "watch and wait" appearance.





If the cave-in of the British market and the November 23 announcement of bank rate rises in the U. S. and England are sounding the death knell for the bull market, we should receive concrete evidence of it, and quickly — from both the Averages and the indicators.

LOW PRICED STOCKS: On November 19, as a whopping 6.1 million shares changed hands, Wall Street witnessed what was probably the most speculative day of 1964. The average price of the 10 most actively traded stocks (which had averaged $39 for the three preceding weeks) dropped to $19.9 on that day. The first five stocks on the most active list for November 19 were Atlas Corp., Madison Square Garden, Benguet, Great Western Fin., and Amer. Photo — all priced under $12.



Such action immediately focuses our attentions on that most profitable (and treacherous) of all stock groups, the low-priced issues — commonly known as "the cats-and-dogs." This sector of the market is one to which I have always given a good deal of attention. The group is important from an academic standpoint because it can aid us in judging the relative age or phase of a bull market. From a practical standpoint, the group is important because on certain occasions it can produce huge profits within a period of perhaps six months to a year.

I have included Chart 2 which traces the action of Barron's Low-Priced Stock Index together with the D-J Industrial Average (monthly) from 1949 to the present. Note on the chart that I have divided the entire bull market into three distinct phases. Referring to classical Dow Theory, the first phase (beginning in 1949 and lasting to January, 1953) represented the rebound from the depressed psychology and conditions of the previous (1948-49) bear market. The next period (1953 to 1957) corresponded to the second phase, in which stocks rose along a broad front in response to obviously improving business conditions. The second phase ended with the severe market reaction of 1957 and the business recession of 1957-58.

The third phase of history's greatest bull market has taken the form of an unprecedented three-pronged rise. During the third phase stocks advance "on hopes and expectations," and it is here that the low-priced stocks make their traditional "flight into space." Judging by past bull markets we would "expect" the third or speculative phase of any bull market to be the shortest phase. But perhaps because our Government (since 1958) has plunged the nation into the greatest expansion of money and credit in world history, the third phase of the bull market has been extended from 1958 to the present.

The extension produced the extraordinary tripart structure pictured on Chart 2. It is most interesting to study the action of the L-P stocks throughout this third phase. Note that during 1958-59, Barron's L-P Index rose almost vertically. A reaction ensued. During 1960-61 Barron's Index rose less steeply with a sharp correction appearing during mid-1961. This was followed by the 1962 crash and the ensuing rise which has lasted to the present. Finally, it is notable that the rise since 1962 has produced a shallow advance in Barron's Index, an advance very different from the two which preceded.

This question now arises: is the shallow 1962-64 rise in Barron's Index an indication of market fatigue or does a steep leg of the L-P advance still lie ahead? As a pure guess, I am inclined to believe that the former is the case. I say this because I believe time may be running out on a further speculative "blow-off," of the type witnessed during 1958-59 (see section on "Britain Moves").

LEADING ANALYSTS (Continued): This week's analyst is Garfield Drew. Mr. Drew's well-known book, "New Methods for Profit in the Stock Market" was first published in 1941, and a revised edition was brought out in 1948. Both editions are market classics, and if you ever come across them — buy them (they have been out of print for years). These books show not only the scope of Drew's knowledge of the market, but they give the reader some idea of the tremendous amount of work this analyst put in before arriving at his own famous (and generally misunderstood) interpretations of the odd-lot transactions. The Drew book details and discusses a large number of important technical market approaches. It is probably a testament to Drew that this subject has never been adequately discussed since (despite the recent renaissance of interest in stock market literature).

Drew wrote his book and started his service under vastly different conditions than those experienced by most of Wall Street's current "good time analysts." As a lesson in history, listen to this quote from the first (1941) edition of the Drew book: "During the past year, the author has been asked by many well-meaning friends why he should publish a book on stock market profits at a time when 'there are no profits'; when financial business is supposed to be just waiting for the knockout punch; when the public is apathetic even to good stocks yielding 7 or 8%; when there is visualized nothing ahead but a long vista or more tightly controlled economy which will choke off all free enterprise, and with it the Stock Exchange which is the nerve center of the whole system."

People who wrote market books and started services in those days were true market enthusiasts. In the rest of Drew's 1941 preface he presents a completely logical thesis — arguing that times will change — that good times have always started from conditions

of despair. How right he was, and how easy it is to say that today.

The Drew Odd-Lot Studies is a weekly report based primarily upon the action of the odd-lotters. The reports and analyses are completely sound, and they have decades of "case histories" to back up their conclusions. Drew draws his conclusions from studies of the odd-lotters' reactions to the "market", both from the short-term and the long-term standpoint. For the latter he uses a three-month average of the monthly ratios. The odd-lot short sales also enter into Drew analyses as do the percentage of odd-lot volume to total N.Y.S.E. volume. Drew also draws upon his vast knowledge of other market phenomena (for instance, the A-D ratio) as well as his own store of experience and philosophy in order to arrive at his conclusions.

What does Drew think now? He believes, based among other things on the low percentage of odd-lot participation and on the still-skeptical attitude of the odd-lotter towards the market, that the current rise has further (perhaps considerably further) to go.

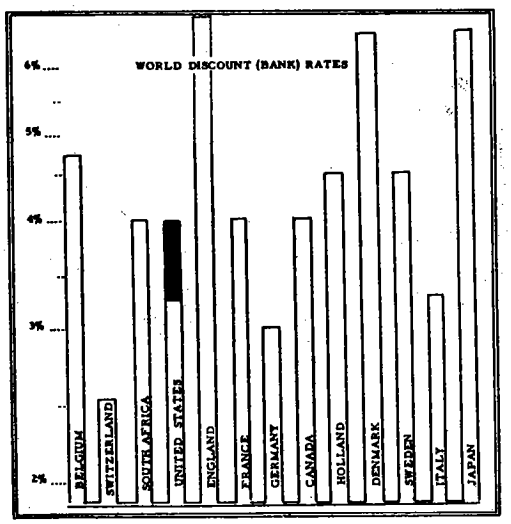
Drew does not believe in flat "predictions" or "crystal ball" forecasts. He believes his studies will tend to identify conditions when they arrive. This attitude, of course, is in the classic tradition of such men as Hamilton and Rhea. ("Neither the extent of the duration of a primary movement can be predicted in advance," wrote Rhea).

Next issue — Mr. Hamilton Bolton.

BRITAIN MOVES: Subscribers are aware of the extended and detailed coverage which I have been giving to the gathering British crisis. Over the past month I have even gone so far as to add the London Financial Times Index to the Composite (page 1) chart. A glance at that chart will show that the London Index is now down about 48 points below its October (377) high, an amount equal to approximately 100 points on our own Industrial Average.

The horrendous British balance-of-payments deficit was announced by the Labor Government to be $2.2 billion, comparable to a deficit of $18 billion in U. S. international deficits! Nevertheless, the Laborites chose to attempt trade restrictions instead of more fundamental monetary restrictions. England placed a surcharge of 15% on most imports while offering export tax benefits. England's European Free Trade partners then raised an immediate roar of protest, and England was forced to announce suspension of the surcharge "in a matter of months."

In the face of this defeat (and U. S. pressure against higher rates to the contrary), England has been forced to move. A man who is bleeding to death does not need "a big friend," he needs a tourniquet. On November 23 England raised her bank rate from 5 to 7% On the same day, the U. S. raised its discount rate to 4% (to protect its own reserves). Letter 260 predicted that this would occur, and I am reprinting and up-dating the world money rate chart which appeared in Letter 260.



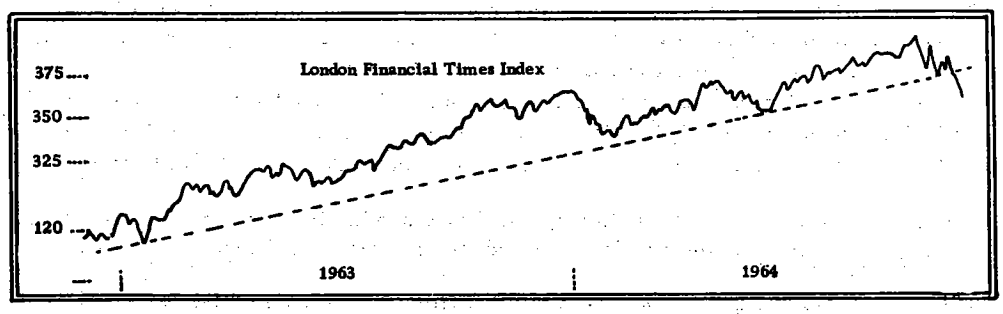
Here is what the chart shows. Of twelve other leading nations of the Free World, six still have higher rates than the U. S. Of the six that do not, France and West Germany have hard currencies and are in good shape. Switzerland has always been a haven for foreign capital; she pays nothing for foreign money kept in her banks. Italy is prevented by the powerful communist party from raising interest rates. South Africa has a strong balance-of-payments and does not need higher rates.

The bellwether for the money market, both here and in Britain, is the 91 day Treasury bill. British bill yields will probably now rise sharply so that they will be in line with the new 7% bank rates (bills usually yield around ½ to 1% less than the bank rate). Suppose the British bill rate goes to 6% in the next month or so. This means that an American buying British bills will receive 6% against probably 3.8 to 4% here. However, there is a risk in the British bill (for Americans) in that the price of sterling may fluctuate. Therefore, most Americans hedge when buying British bills. They immediately buy an equal amount of spot sterling and sell an equal amount of sterling for delivery three months away. This hedge is known as a "cover," and the cost of covering usually runs around ½ to 3/4%. The yield spread between a U. S. bill and a British bill is called the "differential," and when the differential takes into account the cost of covering it is known as the "covered differential."

When the covered differential is around 1% in favor of Britain, there is normally a large flow of U. S. funds to England. If British bill yields now go to 6%, the covered differential could go to 1.25% (assuming a 3/4% cover price and assuming a 4% U.S. bill yield). This means that an individual or corporations buying British bills could gain $12 thousand of interest annually for every million dollars they are holding in U. S. bills. Two things are clear: (1) The U. S. discount rate may be forced to rise again — probably to 5%. (2) The yield spread between fixed income instruments (bonds, bills, etc.) and common stocks is widening — thus putting pressure on the latter.

Conclusion: (1) Savings banks and savings and loan institutions which had been hoping to ease their profit squeeze by lowering their interest rates can now forget about it. (2) Yield conscious subscribers might now purchase covered British 91 day bills. Aside

from the fact that such action hurts our balance-of-payments, I see nothing wrong with it from an investment standpoint. (3) Investors and traders should now be very wary until they see how our market copes with the new round of rate rises.



Finally, I include a chart of the London Financial Times Index. This Index probably made a major peak a month ago in October. The chart shows the Index dropping sharply and breaking the long trendline which has held since January, 1963. Because of the greater sophistication of internationally minded British investors, the London Index has usually turned down before the D-J Industrial Average. For instance, the F. T. Index turned down in January, 1929, eight months before the Dow. The F. T. Index topped in December, 1936, four months ahead of the Dow. In 1946 the F. T. Index turned down in June, one month after the Dow. The F. T. Index turned down in May, 1957, two months before the Dow, and the F. T. Index headed down in December, 1959, one month ahead of the Dow. In 1961 the F. T. Index recorded its peak in April, eight months ahead of the Dow. Whether this relationship will continue remains to be seen.

SUNDRY COMMENTS: With the Democratic Party in full command, many veteran observers and most of the American public believe that more inflation is "in the bag." Such obvious conclusions are always open to question. It should be remembered that at a certain point inflation ceases to be bullish. For many years prices of goods rose ahead of costs, and this proved bullish for profit margins. Costs, after all, consist mostly of labor and cost of material (someone else's costs). But currently costs of goods and labor are moving up ahead of prices. With the glut of merchandise in the U. S. market, the competition from world markets and the added possibility (heightened by his great election mandate) that President Johnson may attempt to keep the lid on certain prices (i. e., steels), it is not certain whether corporations will be able to raise prices fast enough to keep up with costs in the event of further "inflation." This would exert a bearish pressure on profit margins and equity prices. France and Italy ran up against this problem during 1962 and 1963, with the resultant trouble showing clearly in their stock markets.

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A number of subscribers have written to ask: "What about silver?" Here are the facts, and I quote from a recent letter sent by one of my own knowledgeable subscribers (Mr. F. Scicchitano, Westbury, N.Y.): "World production of silver is 200 million ounces; world consumption of silver is 400 million ounces, of which U. S. consumption is 300 million. U. S. stockpiles of silver are now 1.4 billion, and these are being depleted at the rate of 2 to 300 million ounces per year -- or complete dissipation in 4 years. The U. S. Government is increasing coin output to stem speculation (they blame coin collectors). No new mines are in sight at current prices. U. S. needs a defense stockpile of silver. Prices must increase, driving all coins out of circulation (50¢ piece is now worth 48¢ in silver), and thus a silver crisis is foreseen."

The problem of finding a "good" silver stock as a hedge against rising silver prices is a difficult one. I have not been able to find a silver equity which offers any real value in terms of earnings. Day Mines (which has calmed down after its recent excited run-up) offers as good a speculative play as any. Day owns 12 thousand acres in the Coeur d'Alene district of Idaho, which is the richest silver district known in the U. S. Since earnings run around 30-40¢ per share for Day, it is obvious that a purchase of this stock is a speculation on (1) increased earnings for the stock, and (2) further investor excitement about silver (I do not doubt either of these possibilities).

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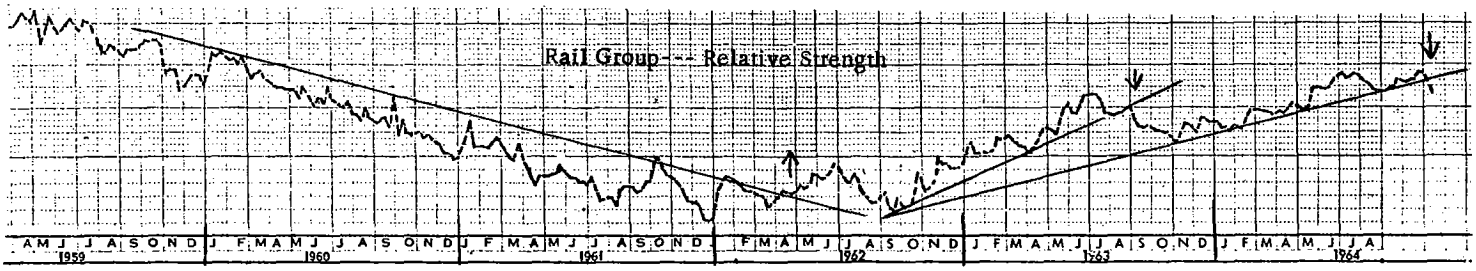
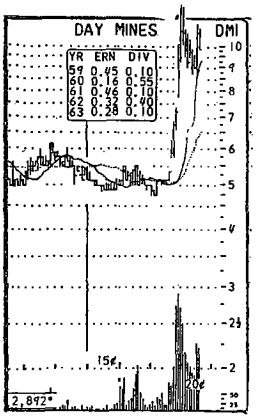
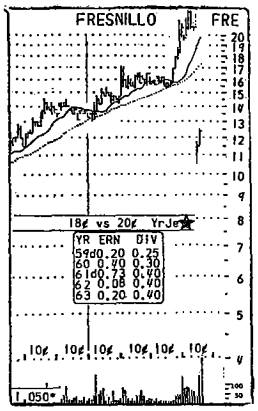
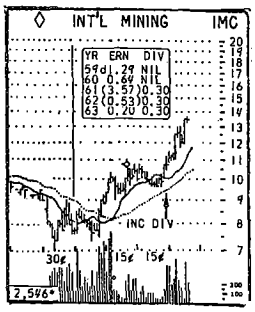
In a number of cases where banks have failed this year, the Federal Deposit Insurance Corporation has held off paying depositors pending an airing of the bank's troubles in court. I have no doubt that all depositors will be paid in full, but this situation immediately points up the advantage of Treasury Bills over bank savings in time of crisis. Some of the greatest bargains in stocks, land, houses, etc., will undoubtedly be up for sale during some panic of the future. At such times it will do the investor little good if his funds are tied up in a bank which may have temporarily suspended operations. Today, during boom times, we see the example of bank depositors who are waiting to receive their money. One wonders what we might see during a major bear market collapse.

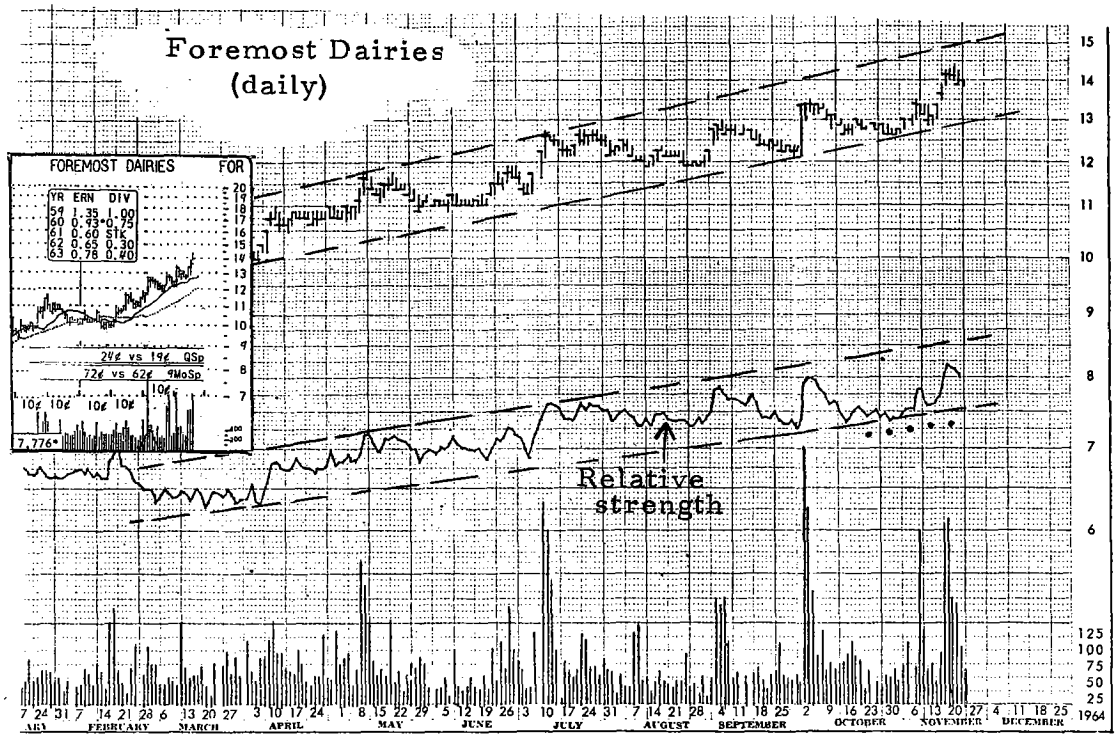
STOCKS: One thing that bothers me here is the growing weakness in rail stocks. I include below a chart of the relative strength (R.S.) of the rail group over the past few years. Note that rail R. S. definitely turned up (reversing a bearish trendline) during April and May of 1962. Rail R. S. rose strongly during most of 1962 and 1963, then corrected during late 1963. A new rise in rail R.S. carried through most of 1964, but over the past month this trendline has been violated. Of 18 individual rail stocks shown in the Traders Research weekly chart book, I count 11 in which the R.S. line has fallen below the 200-day moving average of the R.S. line. This is usually a bearish signal, and it suggests that the majority of rails have now either topped out or are in corrective movements. When the rails have problems, the situation usually has a habit of rubbing off on the whole market.











Many recent recommendations have held up well on this week's sell-off. Standouts were the Variety Retail Chains, McCrory, Grant and Newberry — all at or near highs. International Mining, suggested in Letter 271, also refused to sell off. This interesting stock has a "play" in the metal field including 13% of the total shares of Molybdenum (molybdenum, tungsten), 21% of East Malartic Mines (gold and molybdenum), 7% of Vanadium Corp., 22% of Fresnillo (lead, zinc, silver) plus interests in various Canadian gold mines. Fresnillo, itself, has been a spectacular performer and it, like Day (both shown at left) have been recipients of the silver excitement. Over the past few months both Day and Fresnillo have about doubled in price. Since there is no true quality company producing largely silver, most of the money wishing to assume a position in silver will continue to go into stocks such as Day, Fresnillo, Bunker Hill, N.Y. Honduras and Rosario, Hecla.

Foremost Dairies (Letter 270) is a low-priced situation, and I again include charts of this stock in the Letter. Note that both the price and R.S. in Foremost are climbing steadily along ascending channels. The small weekly chart shows FOR holding well above its 10-week moving average which in turn is holding above the 30-week moving average (dotted line) — a classic bullish situation. This is a "turnaround" situation in a company which had to divest itself of large dairy divisions and is now successfully acquiring new interests. The S.E.C. Official Summary for October shows that the "insiders" seem to like what they are doing for the company. Four directors added to their positions during October, one adding 5,200 shares, two purchasing 1,000 shares each and the last adding 500 shares. Although insider buying is no guarantee of forthcoming "wine and roses," it is nicer to have the insiders with us than ag'in us.

At the risk of boring subscribers, I continue to recommend golds, golds, golds, (see previous Letters). As this is written (mid-day, Wednesday, November 25) the group is powerful and both Canadians and South Africans appear ready to go to new highs.

Chart of FOR and Rail group courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.
Small weekly charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.